



JENNIFER M. GRANHOLM
GOVERNOR

STATE OF MICHIGAN
DEPARTMENT OF TREASURY
LANSING

JAY B. RISING
STATE TREASURER

Tobacco Tax Compliance

Michigan Department of Treasury

History

Michigan has levied an excise tax on cigarettes since 1947. After decades of being assessed at or below 25 cents per pack, Michigan's Cigarette Tax was increased to 75 cents a pack, as part of the implementation of Proposal A in 1994. Since that time, the per-pack Cigarette Tax has been increased twice, to \$1.25 in 2002 and \$2.00 in 2004. Michigan's Cigarette Tax is now the second highest in the nation, behind only New Jersey.

Master Settlement Agreement

In November 1998, 46 states, including Michigan, reached an agreement with five major tobacco companies to settle lawsuits relating to the public costs of treating smoking-related illnesses. This agreement was entitled the Master Settlement Agreement or MSA. The MSA provided for annual payments from the five tobacco companies, to the states, with payments totaling more than \$206 billion by 2025. Michigan received an initial payment of \$107.5 million in December of 1999, with Settlement payments totaling \$1.54 billion through 2004. Annual payments will continue in perpetuity with Michigan scheduled to receive more than \$8.5 billion by 2025.

Cigarette Tax Avoidance

Higher cigarette taxes, and higher costs per pack, have led many smokers to seek alternatives to purchasing taxed cigarettes. The Michigan Department of Treasury has teamed with other state and federal agencies as well as non-government entities in an effort to combat different forms of tax avoidance.

There are five primary ways to avoid paying Michigan taxes on cigarettes:

- Purchase cigarettes from neighboring states, which impose a cigarette tax lower than Michigan's;
- Purchase cigarettes from Michigan retailers who buy large quantities of smuggled cigarettes and can therefore offer lower prices;
- Purchase cigarettes directly from independent smugglers; or
- Purchase cigarettes without paying the tax through sellers located outside Michigan, via the Internet or mail order.
- Purchase untaxed cigarettes from some retail establishments located within an Indian Tribe's "Indian Country".

Cigarettes obtained by any of these means violate the Michigan Tobacco Products Act (MTPA). According to the MTPA (PA 327 of 1993), purchasing cigarettes over the internet, or from any other source outside the state, is illegal unless the purchaser is licensed by the state under the TPTA **or** the seller complies with the Act by stamping each individual pack, collecting the tax due, and remitting the appropriate tax revenues to the state. Prior to 1994, the differential between Michigan's Cigarette Tax and rates in other states was minimal and did not lead to large-scale efforts to buy or sell untaxed cigarettes. However, the incentive to avoid taxation in Michigan became much stronger after the 1994 Cigarette Tax increase took effect. Increases imposed in 2002 and 2004 have resulted in even further cigarette tax avoidance and evasion.

Enforcement Programs & Initiatives

Department of Treasury Tobacco Enforcement Actions

Michigan residents do not have to physically leave the state to illegally avoid payment of cigarette taxes. A form of illegal cigarette smuggling that continues to grow is conducted through mail order and/or Internet sales. In these situations, the seller obtains low-tax or untaxed cigarettes then sells and ships them to either a Michigan resident or business. Recent growth in e-commerce has, in turn, led to growth in on-line cigarette sales. Hundreds of Internet-based sellers advertise and sell so-called "tax-free" cigarettes.

The Michigan Department of Treasury's Bureau of Tax Compliance has taken several steps to curtail this and other practices, in order to collect Cigarette Tax revenues rightly due the state. As part of its Tobacco Enforcement Action Plan, Treasury sent notices to all newspaper publishers in Michigan (Oct. 2004) educating them about provisions of the Tobacco Product Tax Act, the Federal Jenkins Act, and requesting that they not publish advertisements for on-line vendors who fail to comply with the TPTA or Jenkins Act.

Treasury has also partnered with the Bureau of Alcohol, Tobacco, and Firearms, the U.S. Postal Service, the United Parcel Service, Internet Service Providers, and other interested parties to identify more than 450 on-line vendors currently active in Michigan, their physical addresses, and those Michigan residents who have received contraband tobacco shipments and deliveries. As a result of these and other actions, dozens of individuals, with purchases of more than 300 cartons of cigarettes, have been referred to the Michigan State Police and the Department of Attorney General for felony prosecution.

In October 2004, two tobacco Internet vendors submitted Michigan sales information for the period between August 2002 and December 2004.

ESmokes.com provided cigarette purchase information on 6,579 residents. This data shows that a total of 366,478 cartons of untaxed cigarettes were purchased from Esmokes.com, with total tobacco tax due of \$5.4 million. On February 11, 2005, Treasury contacted 532 Michigan residents who had collectively purchased more than 109,000 cartons of cigarettes and therefore owed \$1.6 million to the state. Subsequent mailings to other ESmokes.com customers are forthcoming.

Dirtcheapcig.com has provided cigarette purchase information on more than 5,000 residents. This data shows that a total of 215,330 cartons of untaxed cigarettes were purchased from Dirtcheapcig.com, with a total tobacco tax due of \$3.1 million. Tax Compliance is currently reviewing information regarding these and other on-line purchases, and additional future mailings to residents are expected.

Additional sales information from six other on-line vendors is forthcoming from United Parcel Service (UPS). The six vendors, which all use UPS to ship their product, have to date, failed to respond to department subpoenas. UPS has been subpoenaed for delivery information, specifically, the recipient's name and address.

To help educate Michigan residents about various statutory provisions regarding Cigarette Taxes, as well as restrictions on the purchase and possession of non-stamped cigarettes, the Department of Treasury has issued a number of press releases over the last three years. These releases also detail enforcement efforts and direct citizens to Tobacco Tax information on Treasury's web site (www.michigan.gov/treasury).

Should a Michigan resident become aware that they have somehow purchased untaxed/unstamped cigarettes, Treasury has provided forms with which taxpayers can send in the any Tobacco and Use Taxes that should have been assessed and

collected on those purchases. These residents can avoid penalties and interest that would otherwise be due.

Department of Treasury Interaction with Michigan Indian Tribes

Cigarette sales by retail stores located within a Native American tribe's "Indian Country" pose a unique enforcement problem for states, given the attributes of sovereignty possessed by federally recognized tribes. To address this and other issues, the Department of Treasury has committed significant resources toward establishing specific protocols for all issues involving Indian tribes. In addition, the department has reached out to the tribes in an effort to enhance State/Tribal cooperation and communications.

Specifically, the Department headed negotiations with all twelve of Michigan's federally recognized tribes, in an effort to obtain broad tax agreements that address a variety of taxes, including tobacco. This two year process resulted in agreements with eight of the twelve tribes (Bay Mills Indian Community, Hannahville Indian Community, Little River Band of Ottawa Indians, Little Traverse Bay Bands of Odawa Indians, Nottawaseppi Huron Band of Potawatomi, Pokagon Band of Potawatomi Indians, and Sault Ste. Marie Tribe of Chippewa Indians). These agreements ensure the collection of Michigan tobacco taxes by providing specific protocols for sales within "Indian Country" as well as enforcement provisions allowing the State to audit and inspect within these sovereign lands.

With regards to those tribes which do not have an agreement with the State (Keweenaw Bay Indian Community, Lac Vieux Desert Band of Lake Superior Chippewa Indians, Match-E-Be-Nash-She-Wish Band of Potawatomi Indians and Saginaw Chippewa Indian Tribe), the Department of Treasury continues to monitor and enforce State tax laws, to the extent allowed by federal law. These efforts have resulted in a number of cigarette seizures and a considerable amount of litigation. Currently, the Department is defending such actions in both federal and state courts.

Tobacco Tax Team

Since the enactment of the *Tobacco Products Tax Act* (1994), the Michigan State Police Tobacco Tax Team has undertaken a cooperative effort to enforce the laws, in conjunction with Michigan Department of Treasury, Michigan Attorney General, and Department of Community Health staff. In fact, within the first eight months the *Act* was in effect, more than 44,000 cartons of cigarettes, with an estimated value of \$800,000, were seized. The tax due on these cigarettes was in excess of \$330,000. More than \$225,000 in cash was also seized during these early investigations. In the years since, the Tobacco Tax Team has seized more

than 270,000 cartons of untaxed cigarettes resulting in more than \$6 million in tax and penalty assessments by the Department of Treasury.

Non-Participating Manufacturer (NPM) Enforcement

The Master Settlement Agreement (MSA) provides for reductions in payments from participating manufacturers *if* they lose market share to Non-Participating Manufacturers as the result of a state's failure to enact and enforce a Model Statute designed to neutralize "cost disadvantages" a participating manufacturer experiences in relation to NPMs. In December 1999, Michigan joined other states in addressing this issue by enacting Public Act 244. This law required NPMs to annually establish a qualified escrow fund, if they sell cigarettes (or roll-your-own tobacco) to consumers in Michigan. Escrow funds are maintained for 25 years to pay judgments or settlements on claims against the NPM, brought by the state or "releasing parties" as defined in the MSA. Shortly after enactment of PA 244, the Department of Treasury identified potential NPMs and mailed to them notification of the new law and its escrow requirement.

As an important step in ensuring NPMs comply with this statute, Treasury requested licensed tobacco wholesalers and unclassified acquirers to prepare a *Schedule K* to be submitted with their monthly Tobacco Products Tax return. *Schedule K* shows what products and what quantities were purchased from NPMs. This information is compared to escrow certifications submitted by NPMs and non-compliant NPMs are then referred to the Michigan Attorney General, who may bring civil actions against NPMs who fail to meet escrow requirements.

Enforcement of Requirements for Non-participating Manufacturers

	2000	2001	2002	2003	2004
Contact with known or suspected NPMs	41	86	108	98	40
*NPMs whose products were reported as sold in MI	35	27	46	44	TBD
NPMs depositing funds in qualified escrow accounts for MI	11	15	23	20	TBD
Total deposited in qualified escrow accounts for MI	\$267,756	\$367,881.08	\$1,007,887.97	\$1,633,462.45	TBD
**Cases referred to Michigan Attorney General	6	6	10	15	TBD

* Some NPMs included in this number may later have been found to be incorrectly reported. This number can vary.

**These numbers may include multiple years for a single NPM.

Note regarding 2004 sales: deposits for sales made in Michigan during 2004 are not required until April 15, 2005.

Since 2000, the number of NPMs depositing funds into qualified escrow accounts has nearly doubled. As a result, the total deposited into NPM escrow accounts has grown by nearly \$1.4 million. In addition, Treasury referrals to the Attorney General have also shown a steady increase.

For sales in calendar years 2000 through 2003 the Department has sent 333 letters to known or suspected NPM's whose cigarettes, including 'roll-your-own' tobacco, may have been sold for consumption in Michigan. For sales in calendar year 2004 the Department has sent 40 letters. Additional letters will be sent if new NPM's are found to have their products sold for consumption in Michigan. The number of letters sent has decreased due to improved methods of identifying NPM's. Deposits of 2004 sales were not required until April 15, 2005. Data pertaining to 2004 sales has not been processed as of this date.

The amount deposited by NPM's into qualified escrow accounts for Michigan annually has increased more than 500% from 2000 to 2003. NPM escrow accounts for Michigan now hold more than \$3 million.

The Department has referred more than three dozen cases to the Attorney General for legal action, some of which represent multiple years for a single NPM. The State has obtained 5 court judgements, with additional cases pending. The Department continues to refer accounts to the Attorney General as the need arises.

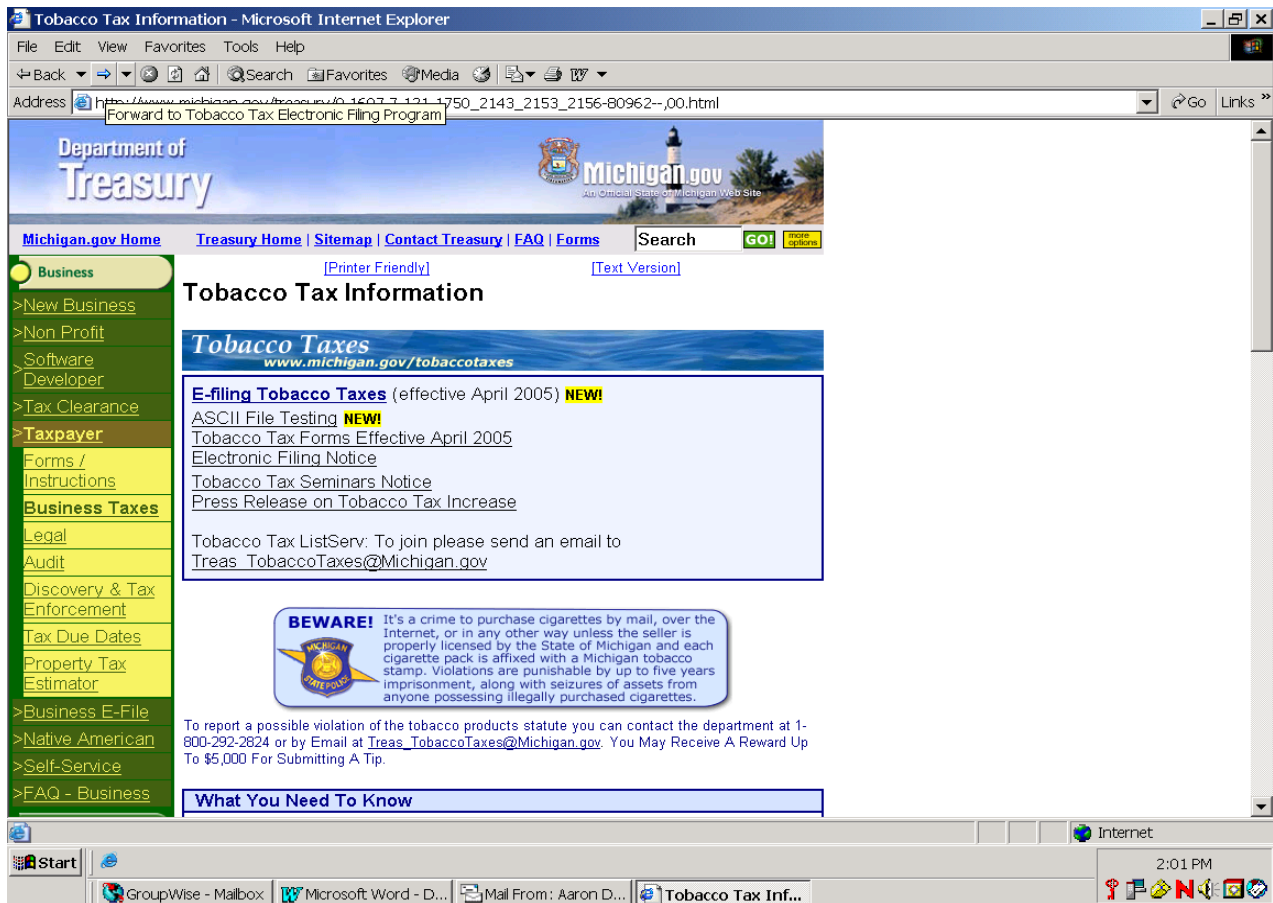
Continuing NPM/Tobacco Tax Enhancements

The Department of Treasury is continually looking for ways to improve its tax systems. The administration and enforcement of the Tobacco Products Tax Act and various issues related to Non-Participating Manufacturers are of particular importance. Current and future initiatives are outlined below:

- PA 327 of 1993 was amended effective July 18, 2002, requiring certain tobacco licensees to provide the report of NPM product to the Department. It also requires NPMs to file an annual certification attesting to their compliance with escrow requirements. Enforcement was strengthened by prohibiting acquisition or sale of non-compliant NPM product, and through extending fines, penalties and seizure provisions to NPM products.
- PA 327 of 1993 was amended on January 8, 2004, which requires Non-participating manufactures to pay an Equity Assessment fee of a minimum of \$10,000.00 prior to commencing business in Michigan. The passage of this bill reduced the number of Non-participating manufactures from over 90 to 14. The bill has reduced the number of manufactures who shipped into our state, however, did not deposit into an escrow account. The bill requires that all non-

participating manufactures report the brand names of the cigarettes and roll-your-own that they will ship into Michigan. This piece of the legislation has allowed for more accurate accounting of non-participating manufacturer's information. The bill also requires that we post on our web site the non-participating manufacturers that have complied with our laws and are able to ship into Michigan.

- A Listserve was established after meeting with a group of licensees. This listserve is used to communicate changes in the Non-participating manufactures that are able to ship tobacco into the state, changes in the tobacco tax act and other useful information.
- The www.michigan.gov/tobaccotaxes web site was established at the request of our licensees. The web site provides the latest information on the tobacco tax.



Links are provided to the Tobacco Products Tax Act, PA 327 of 1993, and other laws that pertain to tobacco taxes. The www.naag.org web site is also provided so tobacco licensees can determine who is a participating manufacturer. The list of non-participating manufacturers who have paid the equity assessment and made their escrow payment and other useful information is housed in one convenient location.

- The biggest deterrent to counterfeit cigarette sales in Michigan is the State's tobacco tax stamp program. The stamps are changed routinely, both in color and additive.
- A Tips Hot Line has been created. This hot line allows concerned taxpayers to submit anonymous information regarding tobacco tax violations. These tips are forwarded to the Treasury Enforcement Team, whose primary duty is the enforcement of the Tobacco Products Tax Act. Those who submit information to the department may receive a reward of up to \$5,000.00.
- System improvements allow for accurate record keeping of non-participating manufacturer information. Additional staff has also been assigned to the collection of Schedule K (NPM data) information.
- Treasury has a primary contact for MSP so they have more access to the information needed to conduct effect inspections of businesses.
- Public Act 474 of 2004 (MCL 205.431) restricts who delivery companies may deliver tobacco tax products to. The statute also requires packages containing tobacco products to be properly marked, which has reduced the number of Internet companies that are able to ship into Michigan.
- The Department of Treasury offers on-going education to tobacco tax licensees to help assure compliance of the Tobacco Products Tax Act.
- During the spring of 2005 Treasury will implement an Automated Tobacco Products Tax System. The new system will enable the department to monitor the distribution of tobacco products at the retail level. This will enable the Enforcement Team to more easily identify violations of the Tobacco Products Tax Act. The new system will also allow for the monitoring of inventory levels of tobacco at the wholesale level, cigarette stamp levels at the wholesale level, and will allow for accurate reconciliation of tobacco tax usage to cigarettes sold. The automated system will give the Enforcement Team the ability to view information electronically that will aid in the identification of possible violations of, as well as the enforcement of, the Tobacco Products Tax Act.

Conclusion

The State of Michigan has taken extensive action to administer and enforce the Tobacco Product Tax Act (TPTA) and to ensure tobacco manufacturers participating in the Master Settlement Agreement are not disadvantaged cost wise, due to shortcomings in enforcement of NPM statutory provisions. As indicated above, Michigan has adopted the national model escrow statute, and augmented it, through amendments to the TPTA. Michigan's enforcement efforts are showing effectiveness in eliminating cost disadvantages to tobacco manufacturers who participated in the Master Settlement Agreement.